DEPARTMENT OF STATE REVENUE

02-20070627.LOF

Letter of Findings: 07-0627
Indiana Corporate Income Tax
For the Tax Year 2003

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ISSUES

I. Adjusted Gross Income Tax–"RAR Modifications."

Authority: IC § 6-3-4-5; IC § 6-3-4-6; IC § 6-8.1-5-1.

Taxpayer protests the Department's decision to not allow certain adjustments that Taxpayer requested on an amended return.

II. Adjusted Gross Income Tax–Consolidated Group.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-2; IC § 6-3-4-14; IC § 6-8.1-5-1; 45 IAC 3.1-1-38; Cooper Industries v. Indiana Dep't of State Revenue, 673 N.E.2d 1209 (Ind. Tax Ct. 1996); Allison Engine Co, Inc. v. Indiana Dep't of State Revenue, 744 N.E.2d 606 (Ind. Tax Ct. 2001); Enterprise Leasing Co. v. Indiana Dep't. of State Revenue, 779 N.E.2d 1284 (Ind. Tax Ct. 2002); Walker Manufacturing Co. v. Dep't of Local Government Finance, 772 N.E.2d 1 (Ind. Tax Ct. 2002); 15 USC § 381.

Taxpayer protests the Department's decision to not allow certain adjustments that Taxpayer requested on a second amended return.

III. Adjusted Gross Income Tax–Bonus Depreciation.

Authority: IC § 6-3-1-3.5; IC § 6-8.1-5-1.

Taxpayer protests the Department's decision to not allow certain adjustments that Taxpayer requested on an amended return.

IV. Adjusted Gross Income Tax–Net Operating Loss.

Authority: IC § 6-8.1-5-1.

Taxpayer protests the Department's decision to not allow certain adjustments that Taxpayer requested on an amended return.

STATEMENT OF FACTS

Taxpayer is a multi-structured manufacturing and insurance business consisting of a parent corporation ("parent") and numerous subsidiaries. For the tax year 2003, Taxpayer filed a consolidated Indiana adjusted gross income tax return to report the parent and subsidiaries' income from Indiana activities for its two consolidated groups. Taxpayer has one consolidated group for its life insurance companies ("life group") and one consolidated group for all of its other companies, or the non-life insurance companies ("non-life group").

Taxpayer's first amended return, dated August 3, 2005, requested a refund of $2,400,594 resulting from certain adjustments related to the addition of a South Carolina entity to its consolidated return and to an increase in the amount of its research and development credits. The Department conducted an investigation of the amended return. The Department issued an audit report dated November 10, 2005, making the determination that only the change to research and development credits was allowed, the other changes were denied, and a refund in the amount of $521,208.29 was granted. The Department's audit report found that the South Carolina entity could not be included in the consolidated return because it did not have income from Indiana sources as required by IC § 6-3-4-14(b). The Department's audit report concluded that the South Carolina entity did not have income from Indiana sources because it did not have Indiana sales, did not have Indiana taxable income, and the inventory reported as stored in Indiana was de minimis. On January 20, 2006, Taxpayer received the November 10, 2005, audit report with the Department's January 13, 2006, letter, which provided as follows:

> The results of a recent examination completed by the Audit Division for **Income Tax** for tax period 10/01/2002 to 09/30/2005 indicated that you are entitled to a refund. Enclosed for your review is a copy of the audit report.
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> If you agree with the audit/investigation results, no action is necessary. The refund check was issued [sic] on 01/17/2006. If you disagree, your right to protest is as follows:
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> > If the refund has been generated by an audit/investigation and you disagree with the results, you have sixty (60) days from the date of this letter to file a protest and request a hearing. (IC 6-8.1-5-1[c]) The enclosed booklet, **Protest Procedures**, outlines the procedures to follow.
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> (**Emphasis in original.**)

A protest of the Department's determination in the audit report was never filed by Taxpayer.

On June 19, 2007, Taxpayer filed a second amended return to "report IRS Audit Adjustments for FYE 9/2002 to 9/2003 (And corresponding effect on state addbacks/substractions)." Taxpayer included a copy of the Internal Revenue Service's RAR modification reported dated July, 21, 2006. In this June 19, 2007, amended return,

Taxpayer included numbers that not only reported additions to its Indiana adjusted gross income from the federal audit adjustments, but reflected the other adjustments that were denied in the Department's November 10, 2005, audit report. This amended return requested a refund in the amount of $2,400,594. The Department processed the return by making the adjustments from the federal RAR modification report and issued a proposed assessment for the 2003 tax year reflecting the additional tax due. Taxpayer protested the assessment. An administrative hearing was held, and this Letter of Findings results.

I. Adjusted Gross Income Tax–"RAR Modifications."

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

The Department adjusted Taxpayer's 2003 adjusted gross income tax to reflect the modifications to Taxpayer's federal taxable income as provided by the Internal Revenue Service ("IRS") in the RAR modification reported dated July 21, 2006, which resulted in an increase in Taxpayer's Indiana adjusted gross income for the 2003 tax year.

Taxpayer requests that only the modifications, which it has not appealed with the IRS, should be made, thereby, delaying its payment to the Department of the tax due until the appeal has been addressed. Taxpayer invites the Department to ignore one of the modifications made by the Internal Revenue Service ("IRS") in the RAR report because Taxpayer has appealed that modification with the IRS. However, the Department declines to accept Taxpayer's invitation.

Pursuant to IC § 6-3-4-6(c), when a taxpayer has received federal modifications and "the federal modification results in a change in the taxpayer's federal or Indiana adjusted gross income, the taxpayer shall file an Indiana amended return within one hundred twenty (120) days after the modification is made." Moreover, IC § 6-3-4-5 provides that upon requirement to make a return the taxpayer "shall, without assessment or notice and demand from the department, pay such tax to the department at the time fixed for filing the return." Accordingly, Taxpayer upon receiving the federal modifications is required by statute to file the amended return reflecting the federal modifications and to pay the tax due.

Taxpayer's proper remedy is to file an amended return if and when a later determination of the IRS is provided in a federal modification RAR report. This is, especially, true in cases such as this, when a taxpayer is appealing the IRS's modifications and a loss of appeal results in no need for the IRS, and the Department for that matter, to make a later modification.

FINDING

Taxpayer's protest is denied.

II. Adjusted Gross Income Tax–Consolidated Group.

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

Taxpayer maintains that it should be allowed to adjust its original filing group of its consolidated return by including a South Carolina entity in and excluding another entity ("Other Entity") from the consolidated "non-life group." Taxpayer asserts that it first discovered that the South Carolina entity had Indiana nexus in 2005 and that it should be included in the consolidated "non-life group." Taxpayer also asserts it discovered in 2007 that another entity that it originally included in its consolidated "non-life group" did not have Indiana nexus beyond the mere solicitation of sales as provided in PL 86-272 and should be excluded.

A. Additional Subsidiaries.

1. South Carolina Entity.

The Department's audit report dated November 10, 2005, found that even though the South Carolina entity had a de minimis amount of inventory in Indiana, the South Carolina entity could not be included in the consolidated return because it did not have adjusted gross income from Indiana sources as required by IC § 6-3-4-14(b). On January 20, 2006, Taxpayer received the November 10, 2005, audit report, and did not protest the Department's determination.

Since Taxpayer failed to protest the Department's determination and made identical claims on the later return ignoring the Department's determination, Taxpayer's protest is barred by the statute of limitations. The part of Taxpayer's second claim that is identical to the first is an impermissible attempt to resurrect the first claim, which was not timely appealed. Therefore, Taxpayer is precluded from now asserting those claims. See Walker Manufacturing Co. v. Dep't of Local Government Finance, 772 N.E.2d 1, 6-7 (Ind. Tax Ct. 2002) (finding the tax court lack subject matter jurisdiction over a re-filed petition to reclassify land); See also Allison Engine Co, Inc. v. Indiana Dep't of State Revenue, 744 N.E.2d 606, 609-611 (Ind. Tax Ct. 2001).

Notwithstanding, even if Taxpayer had timely protested this issue, Taxpayer's protest would have been denied. Taxpayer in the August 3, 2005, and the June 19, 2007, amended return maintained that the South Carolina entity has receipts from inter-company transactions, which are eliminated at the federal level, and a small amount of inventory in Indiana that creates nexus with Indiana by establishing "adjusted gross income derived from sources within the state of Indiana" as provided in IC § 6-3-4-14(b).

Pursuant to IC § 6-3-4-14(a)-(b), "[A]n affiliated group of corporations shall have the privilege of making a

consolidated return with respect to the taxes imposed by IC 6-3... with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana." (Emphasis Added). Additionally, IC § 6-3-1-3.5(b) provides that "'adjusted gross income' shall mean.... [i]n the case of corporations, the same as 'taxable income' as defined in Section 63 of the Internal Revenue Code," with certain adjustments. The Tax Court has determined that for income to be in the taxpayer's Indiana adjusted gross income, the income must be included in the taxpayer's federal taxable income. For example, in Cooper Industries v. Indiana Department of State Revenue, 673 N.E.2d 1209, 1212-1213 (Ind. Tax Ct. 1996), the court found:

> The Indiana Code provides that "the term 'adjusted gross income' shall mean.... [i]n the case of corporations, the same as 'taxable income' as defined in Section 63 of the Internal Revenue Code," subject to four adjustments that are not applicable here. Ind.Code Ann. § 6-3-1-3.5(b). This definition is plain and unambiguous. Indiana adjusted gross income begins with federal taxable income as defined by I.R.C. § 63, not as reported by the taxpayer. Thus, the issue is not what number appears on line 28 of a taxpayer's federal income tax form 1120 but whether a particular item of income was included in taxable income pursuant to I.R.C. § 63.
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> ...
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> In F.A. Wilhelm, this Court held that if an item of purported income is not included in "taxable income" under I.R.C. § 63, then it is not included in "adjusted gross income" under Ind.Code Ann. § 6-3-1-3.5(b). 586 N.E.2d at 956.

Accordingly, since the South Carolina entity's receipts are not included in the Taxpayer's federal taxable income, the South Carolina entity's receipts are not included in Indiana adjusted gross income. Thus, the receipts cannot create adjusted gross income derived from Indiana sources.

Moreover, Taxpayer seeks to gain nexus by retaining a de minimis–in Taxpayer's case less than four percent–amount of its inventory in Indiana, which as determined in the audit report dated November 10, 2005, does not create nexus in Indiana. IC § 6-3-2-2(a)(2), provides that when a taxpayer has " income from doing business in this state," the taxpayer has "adjusted gross income derived from sources within Indiana." (Emphasis added). For apportionment purposes, the Department's regulations state that a taxpayer is "doing business" in a state when it engages in the "[m]aintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods." 45 IAC 3.1-1-38(2). Therefore, for the "maintenance of an inventory of merchandise or materials [that are] for sale[s] distribution" to create nexus, the inventory must create income.

First, since the South Carolina entity only sold to the related entity in Indiana, the inventory in Indiana lead to inter-company sales, which are eliminated at the federal level and do not create income, let alone Indiana adjusted gross income. Second, since the South Carolina entity has neither any employees performing inventory work in Indiana nor a warehouse or other place to hold inventory in Indiana, Taxpayer is not engaging in the "maintenance" of an inventory for sale[s] distribution in Indiana. In fact, based upon this lack of employees and property in Indiana, it is likely that the inventory is actually the inventory of a related entity. See Enterprise Leasing Co. v. Indiana Dept. of State Revenue, 779 N.E.2d 1284, 1294 (Ind. Tax Ct. 2002) (providing that property located in Indiana used by a third party is not business property includable in the numerator of the property factor of the owner of the property). Lastly, allowing a taxpayer to create nexus with a non-income generating, de minimis connection to Indiana potentially leads to distortion of the taxpayer's Indiana adjusted gross income. In Taxpayer's case, by including the South Carolina entity in the consolidated return, based upon less than four percent of its total inventory, reduces the Taxpayer's Indiana adjusted gross income by nearly $11,000,000.

Therefore, Taxpayer's protest is denied.

2. Other Entity.

Taxpayer included Other Entity in its originally filed return with an apportionment factor consisting of only a receipts factor. Taxpayer maintains that since it did not have property or payroll in Indiana that did not have nexus exceeding P.L. 86-272 (15 USC § 381).

However, during the course of the protest, Taxpayer failed to provide any information about the Taxpayer's business operations to support its assertion. Moreover, Taxpayer was asked by the Department to support its assertion by supplying the original return(s) and the amended return(s) it filed in the other state(s) reflecting this amendment of excluding the Other Entity from the Indiana return. However, Taxpayer failed to provide the other state(s) return(s) and stated that it did not amend its other state(s) return(s) in which this company originally filed. If these receipts were removed from Indiana based upon P.L 86-272, then these sales, most likely, would have been thrown-back to state(s) of the sales origination. Taxpayer's apparent lack of filing the other state return(s) shows inconsistency in Taxpayer's treatment of this entity and these sales/receipts. Furthermore, since Taxpayer registered the Other Entity, as a domestic Indiana corporation, with the Indiana Secretary of State and Taxpayer's own SEC 10-K annual report filings list the entity as a Indiana corporation, it is unlikely that P.L. 86-272 would apply.

Therefore, Taxpayer's protest is denied.

B. Foreign Source Dividend Deduction.

Taxpayer asserts that its originally reported foreign source dividends deduction was incorrect. Taxpayer

maintains that it should be allowed to adjust its foreign source dividend deduction from $5,517,537 to $19,719,997. On its 2003 tax year original return taxpayer reported $4,684,780 as federal deduction for qualifying dividends on line 2 and a foreign source dividend deduction in the amount of $5,517,537 on its schedule H as reported in line 30. On the amended return taxpayer has wrongfully included this $4,684,780 federal deduction for qualifying dividends in its foreign source dividend deduction on its schedule H as reported in line 30. This $4,684,780 federal deduction for qualifying dividends is properly reported, as the Department reports it, on line 2.

In addition, the other part of the Taxpayer's requested adjustment pertains to Taxpayer's inclusion of the South Carolina entity's (as discussed in subpart A(1)) foreign source dividends deduction in the amount of $3,489,494 and federal deduction for qualifying dividends in the amount of $5,644,662 on its schedule H as reported in line 30. As stated previously, these adjustments are not warranted. See subpart A(1).

Therefore, Taxpayer's protest is denied.

C. Apportionment.

Taxpayer asserts that the originally reported apportionment for its "life group" and its "non-life group" were incorrect. Taxpayer maintains that it originally reported its "life group's" 6.69 percent apportionment and "non-life group's" 25.07 percent apportionment as a combined apportionment of 25.19 percent and calculated its Indiana adjusted gross income using this combined apportionment figure. Taxpayer also asserts that not only does each group's separate apportionment percent need to be used to determine the tax due for each group, but its "non-life group" apportionment needs to be adjusted from 25.07 percent to 22.84 percent.

However, the Taxpayer-requested adjustment actually pertains to Taxpayer's inclusion of the South Carolina entity's (as discussed in subpart A(1)) apportionment factors in the "non-life group's" apportionment and the exclusion of the Other entity (as discussed in subpart A(2)) apportionment factors in the "non-life group's" apportionment. As previously stated, these adjustments are not warranted. See subparts A(1) and A(2).

Therefore, Taxpayer's protest is denied.

FINDING

In summary, Taxpayer's protests of subparts A(1), A(2), B, and C are denied.

III. Adjusted Gross Income Tax–Bonus Depreciation.

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

Pursuant to IC § 6-3-1-3.5(b)(5), to determine a corporate taxpayer's Indiana adjusted gross income the taxpayer's federal taxable income is modified to disallow the amounts of bonus depreciation that the taxpayer elected to claim as a deduction on its federal return and to adjust the taxpayer's income to what it would be if the election for bonus depreciation had not been made.

Taxpayer originally filed its 2003 Indiana adjusted gross income tax return with a modification for bonus depreciation adding-back $13,777,133. Taxpayer asserts that this originally reported bonus depreciation add-back of $13,777,133 was incorrect. Taxpayer maintains that it should be allowed to adjust its bonus depreciation add-back to $9,265,879 as Taxpayer requested on the June 19, 2007, amended return.

During the course of the protest, Taxpayer submitted its federal adjusted gross income tax return and a portion of the workpapers from an Illinois Department of Revenue audit detailing the amount of bonus depreciation add-back determined for Illinois for certain assets that were purchased by entities in Taxpayer's consolidated group. However, the originally reported bonus depreciation that Taxpayer reported in Illinois for certain of its entities was not the same as the originally reported bonus depreciation Taxpayer reported for Indiana. Moreover, Taxpayer did not provide a copy of its Federal Form 4562 detailing the depreciation deductions that were taken on its federal consolidated adjusted gross income tax return. Despite the fact that Taxpayer provided a copy of its federal consolidated return that contained a schedule showing the income and deduction information for each entity in the consolidated return, this schedule only provided the total amount of depreciation deduction taken for each entity and did not differentiate between the bonus depreciation and the other depreciation. Thus, the information provided by Taxpayer failed to fully account for the federal depreciation deductions that were taken by Taxpayer for the entities on the Indiana consolidated return.

While the information provided by Taxpayer was insufficient to demonstrate that the bonus depreciation add-back should be adjusted to $9,265,879, the information provided by Taxpayer does show that for some of the entities the bonus depreciation add-back should be adjusted. The information provided in the federal returns and the Illinois audit workpapers does show that for certain of the entities the bonus depreciation add-back should have been greater than what was originally claimed and should be increased. Therefore, Taxpayer's protest is sustained in part, to the extent that the information provided by Taxpayer for the bonus depreciation add-back supports an increase in bonus depreciation add-back for a certain entity as requested by Taxpayer on its June 19, 2007, amended return. In addition, there is a possibility that, for certain entities, for which the federal depreciation deductions can be fully accounted and Taxpayer has requested a decrease in the add-back, a decrease to the add-back is warranted. Therefore, Taxpayer's protest is sustained in part, to the extent that the information provided by Taxpayer accounts for all the depreciation taken on the federal return and reflects a decrease in the amount of bonus depreciation add-back for a certain entity as requested by Taxpayer on its June 19, 2007,

amended return. However, Taxpayer's protest is denied, to the extent that the information provided by Taxpayer does not account for all of the depreciation taken on the federal return and reflects a decrease in the amount of bonus depreciation add-back for a certain entity as requested by Taxpayer on its June 19, 2007, amended return.

Therefore, Taxpayer's protest is sustained in part, subject to audit verification, for the bonus depreciation add-back modification to be adjusted for certain entities, but is denied in part as to the amount of the total adjustment requested. The file will be returned to the audit division to incorporate the allowable amount of adjustments to the bonus depreciation add-back.

FINDING

Taxpayer's protest is denied in part and sustained in part subject to audit verification.

IV. Adjusted Gross Income Tax–Net Operating Loss.

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

Taxpayer maintains that it should be allowed to carryback a 2004 "life group" net operating loss of its "life group" to the 2003 tax year. During the course of the protest, the Department requested Taxpayer to file amended returns for the 2003 and 2004 tax years reflecting this adjustment. Taxpayer filed the amended returns, date May 21, 2008, to carryback the 2004 "life group" net operating loss to the 2003 tax year. Taxpayer has provided sufficient documentation to demonstrate that the 2004 "life group" loss should be carried back in a net operating loss deduction for the 2003 "life group." Therefore, Taxpayer has met is burden of proof.

FINDING

Taxpayer's protest is sustained.

CONCLUSION

In summary, Taxpayer's protests of Issue I, Issue II(A), Issue II(B), and Issue II(C) are denied, and Taxpayer's protest of Issue IV is sustained. Taxpayer's protest of Issue III is sustained in part, subject to audit verification, for the bonus depreciation add-back modification to be adjusted for certain entities, but is denied in part as to the amount of the total adjustment requested.

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